BUSINESS LAW SECTION

CORPORATIONS COMMITTEE
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TO: Office of Governmental Affairs

FROM: W. Derrick Britt, Vice Chair Legislation
Corporations Committee of the Business Law Section of the State Bar of California

RE: A.B. 2944 (Leno), as introduced

Committee Position:

☒ Oppose

Date position recommended:	April 13, 2008	
Standing Committee vote:	April 4, 2008: 16-0 (with delegation of authority to drafting committee)	April 14, 2008 6-0 (drafting committee approval of revisions, per delegated authority)
Business Law Section Executive Committee vote:	April 8, 2008: 16-0 (delegation of authority to Legislative Subcommittee)	April 12, 2008: 7-0 (vote of Legislative Subcommittee)
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I. Statement of Position

The Corporations Committee (the "Committee") of the Business Law Section of the State Bar of California (the "Section") welcomes this opportunity to comment upon AB 2944 (the "Bill"). This is the first statement of position that the Committee has submitted on this matter. The Committee opposes the Bill as drafted.

A. Description of A.B. 2944.

The proposed revisions to Section 309 of the California Corporations Code (the "Code") would permit a director, in considering the best interests of the corporation, to consider the interests of the corporation's employees, the impact on the community, and the environment.

B. The Committee's Position.

EXECUTIVE SUMMARY

The Bill would expand the factors that corporate directors may consider when deciding to take corporate action beyond "the best interests of the corporation and its shareholders" to specifically include the interests of the corporation's employees, the impact on the community and the environment.[1] Directors who consider such interests in properly exercising their duty of care shall have no liability based on any alleged failure to discharge their duties as directors.

Instead of promoting corporate social responsibility, the Committee believes that the Bill would lead to less director accountability, less responsive corporate governance and, ultimately, less socially responsible corporate behavior, for the following reasons:

- The Bill would undermine director accountability to shareholders without effectively promoting interests of non-shareholder constituents.[2]
- The Bill is unnecessary because current law is not an impediment to responsible corporate behavior and there are less intrusive means of protecting the interest of non-shareholder constituents.
- The Bill has the potential for causing significant economic harm to shareholders and the public generally.

[1] We understand there are some corporations that desire to institutionalize an intention to create benefit for interests and interest groups beyond the traditional interests of shareholders (popularly referred to as "B corporations"). If the purpose of the Bill is to permit such B corporations to memorialize that intention in their governing documents, the proposal should be specifically limited to that purpose so legislators and interested persons can assess the impact and address any comments or concerns on that basis. Because the Bill in its current form would apply to all corporations (not just B corporations that elected to have such provisions apply, if permitted to do so), our comments must be provided on the more expansive policy and legal considerations that are raised by the Bill as drafted.

[2] The term "constituents" is popularly used to refer collectively both to groups that have legally-recognized interests in corporations (*e.g.*, shareholders) and to groups that are asserted to have another form of interest (*e.g.*, the community at large, vendors, customers). In that sense the term is often used to assume a legal conclusion: that such other groups have interests that are or should be comparable to the interests of shareholders. That term is used here solely because of its increasing prevalence in popular, non-legal analysis of corporations but should not be construed as a conclusion by the Committee that such external interests do have such rights.

1. Corporate Governance Concerns

The Bill represents a renewed attempt to expand the standard of care for corporate directors to allow them to consider interests unrelated to the best interests of shareholders. As with the Committee's concerns voiced in response to Senate Bill 1528 proposed in 2004 (which contained provisions similar to the provisions proposed in this Bill), the Committee has the following concerns with the current Bill:

- **The Bill would make directors less accountable.** The Bill would modify a longstanding standard of director accountability in California with a rule that would allow directors to invoke reasons for their decisions that are unrelated to the best interests of shareholders. As one commentator has noted, provisions like those contained in the Bill "could leave [directors] so much discretion that [they] could easily pursue their own agenda, one that might maximize neither shareholder, employee, consumer, nor national wealth, only their own."[3] By adding to the universe of interests which directors may consider (even those in conflict with interests of the shareholders, to whom directors owe a duty of care), the Bill is not offering a choice between responsible or irresponsible corporate behavior *but instead is providing another means for directors to escape accountability*. It is important to note that Institutional Shareholder Services, Inc., an influential proxy and corporate governance advisory firm, counts incorporation in a state with non-shareholder constituency provisions like those contained in the Bill as a negative factor when calculating its Corporate Governance Quotient, a well-known standard for measuring the quality of corporate governance.

- **The Bill has the effect of an anti-takeover measure that would entrench directors and management**. Legislation of this type has been enacted in other states for the purpose of adding to the corporate arsenal of anti-takeover devices. In this, the Bill is directly contrary to recent legal trends toward greater shareholder democracy and more responsive corporate governance. Thus, the Bill would serve to entrench directors by giving them defenses against shareholder lawsuits, making it easier for them to escape the consequences of failure to meet their fiduciary duties to shareholders.

- **The Bill establishes no standards, thereby burdening conscientious directors**. While some directors could employ the provisions of the Bill to weaken their accountability to shareholders, conscientious directors would be burdened by the diverse and conflicting interests presented. The Bill provides a list of three additional constituent factors for directors to consider, with no guidance as to what weight to give each factor, nor any procedure for deciding among competing factors. Despite the permissive language of the Bill, proponents of similar legislation have argued that they nonetheless create enforceable rights that non-shareholder constituents can pursue through litigation against directors.[4] At a time when corporate boards desperately need capable and committed members, this increased potential for liability can be expected to deter qualified director

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[3] Mark J. Roe, *The Shareholder Wealth Maximization Norm and Industrial Organization*, 149 U. PA. L. REV. 2063, 2065 (2001).

[4] *See. e.g.*, David Millon, *Redefining Corporate Law*, 24 IND. L. REV. 223, 227 (1991); Lawrence E. Mitchell, *A Theoretical and Practical Framework for Enforcing Corporate Constituency Statutes*, 70 TEX. L. REV. 579 (1992).

candidates from serving; compounding the corporate governance problems the Bill will create.

2. Directors' Duty of Care and Corporate Social Responsibility

The Bill seeks to promote corporate social responsibility by taking away the threat of shareholder lawsuits against directors who wish to consider the interest of three non-shareholder constituents. The underlying premise for this legislation is that the threat of such suits is currently a significant constraint against the actions of socially responsible corporate directors. The Committee is not aware of any evidence that the current statutory formulation of the duty of care in Section 309 of the Corporations Code is the cause of socially irresponsible behavior on the part of California corporations. Further, the Committee is unaware of any provision of California law that prevents directors adopting socially responsible corporate policies.

The Bill's necessity is further undermined by the fact that there are more effective means available to the Legislature to deal with employee protections, community impact of corporate conduct and environmental protection, including the many laws that are already in effect to address these matters. Part of a board of directors' fiduciary duties to shareholders involves ensuring that a corporation has appropriate policies in place to comply with such laws. The Committee believes that the non-shareholder concerns expressed in the Bill are better protected by existing and future laws focused on the specific conduct of corporations instead of modifying the delicate legal machinery that provides shareholders with the primary means they have of ensuring that the caretakers of their investments faithfully discharge their duties to such shareholders.

3. Economic Impact

By deviating from the standard of shareholder primacy in corporate governance, the Bill can be expected to impair the bottom-line profitability of California corporations. This diversion of management's focus from enhancing the investments made by shareholders, together with the uncertain application of the Bill's vague provisions, almost certainly will have the unintended effect of making it more difficult and expensive for California corporations to attract equity and debt investment.[5]

The economic impact of the Bill may lead many entrepreneurs not to incorporate in California, and may lead many California corporations to reincorporate in jurisdictions more hospitable to the concerns of shareholders, such as Delaware. Moreover, because Section 2115 of the Corporations Code subjects "quasi-California" corporations to Section 309, the Bill could have the effect of further deterring businesses organized as foreign corporations from choosing to locate and do business in California.

II. GERMANENESS

The Committee believes that its members have the special knowledge, training, experience and technical expertise to provide helpful comments on the Bill, and that the positions advocated in this report

[5] The Committee notes that non-shareholder constituency statutes are routinely listed as risk factors in prospectuses and other disclosure documents for investors.

would promote clarity and consistency in the law and improve coordination between state and federal law in the regulation of corporate disclosure.

III. CAVEAT

This statement is that only of the Committee. The positions expressed herein have not been adopted by the Section or its overall membership or by the State Bar's Board of Governors or its overall membership, and are not to be construed as representing the position of the State Bar of California. There are currently more than 8,800 members of the Section. Membership in the Section is voluntary and funding for its activities, including all legislative activities, is obtained entirely from voluntary sources.

cc: Steven K. Hazen
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